

86-10050

STAFF COPY. DO NOT REMOVE



**Directorate of  
Intelligence**

**Confidential**

25X1

# **The Islamic Economic System and Its Prospects in Iran**

25X1

**A Research Paper**

**Confidential**

*NESA 86-10050  
December 1986*

**Page Denied**



**Directorate of  
Intelligence**

**Confidential**

25X1

# **The Islamic Economic System and Its Prospects in Iran**

25X1

**A Research Paper**

This paper was prepared by a contractor with the  
Office of Near Eastern and South Asian Analysis.  
Comments and queries are welcome and may be  
directed to the Chief, Persian Gulf Division, NESA,

25X1

*Reverse Blank*

**Confidential**

**Confidential**

25X1

## **The Islamic Economic System and Its Prospects in Iran**

25X1

### **Summary**

*Information available  
as of 3 November 1986  
was used in this report.*

The Islamic economic system, under which market practices and the distribution of income reflect Koranic teachings, has little future in today's turbulent Muslim world—even in Iran, where the system is furthest advanced.

25X1

The model Islamic economic system serves as a subordinate component of a militant Islamic state whose people believe in the primacy of Allah, His ownership of productive resources, and the position of man as His trustee in the allocation of these resources.

25X1

The Islamic economic system features the following operational characteristics:

- Private ownership and use of productive resources within religiously determined constraints.
- Support of the poor by the well-to-do through alms taxes, charitable contributions, and the payment of fair wages.
- Strict prohibitions against the payment of interest as not justified by labor effort or risk.
- Bans on pork, liquor, prostitution, gambling, speculation, and hoarding.
- A code of fair dealing in the marketplace that prohibits taking advantage of the ignorance or poverty of either buyer or seller.
- The greatest possible reliance on goods and technology from domestic sources or from other Islamic countries.

25X1

Since Ayatollah Khomeini's accession to power on 11 February 1979, his government has installed the Islamic economic system only in piecemeal fashion because of the survival of strong secularist elements, the preoccupation with the bloody war with Iraq (now in its seventh year), and the Ayatollah's lack of attention to economic affairs.

25X1

The revolutionary regime has failed to arrange for private operation of the large industrial enterprises seized from the Shah's supporters or to settle disputes over land ownership that resulted from the Shah's land reform and the flight of many landowners. The new regime has generally succeeded in establishing minimum levels of consumption through the rationing of basic items, but the poor still suffer bitterly from the drastic overcrowding of housing, growing shortages of consumer goods, dislocations stemming from the war, a 20-percent annual inflation rate, and massive unemployment. The nationalized banking system continues to pay interest under the guise

**Confidential**

NES 86-10050

**Confidential**  

25X1

of dividends from pooled investment funds, and private currency transactions flourish at several times the official exchange rates. While conforming to the Islamic code of behavior in public, people continue to drink alcohol and enjoy luxuries in private. The marketplace retains its traditional Iranian qualities of lively wheeling and dealing, illegal trafficking in smuggled and rationed goods, bribery, and the sale of some goods of abysmally low quality. As for economic self-reliance, oil still must be sold and weapons procured in non-Islamic markets, despite the oft-repeated slogan "neither East nor West." Population has risen rapidly under the Ayatollah—from 37 million to 46 million people—without a like increase in food production, housing, utilities, and jobs.

25X1

The Islamic economic system in Iran probably has reached its high water mark. Once Iran loses the unifying influence of the Ayatollah, the spiritual energy necessary for the further development of the system almost certainly will fade. When the war ends, the Iranian people will have to address the secular tasks of pumping more oil, replacing deteriorated industrial plant, and securing additional quantities of food. Broad trade and educational contacts with the secular West will continue. The conflicting interests of religious and technocratic factions, formerly held in rough balance by the authority of the Ayatollah and the requirements of war, will have to be sorted out.

25X1

Secular-minded rulers govern the other Muslim states, which have retained their close links to foreign sources of technology and weapons, thus drawing fire from militant advocates of thoroughgoing Islamization. The militants assert that today in every Muslim society an Islamic revolution—like Iran's—is waiting to be born in order to uphold Allah's oneness and supreme power. To judge from Iran's experience since the revolution, however, other Muslim countries will not adopt truly Islamic economic systems in view of their present secular tilt and the strength of global technological and secular forces.

25X1

**Confidential**

**Confidential**

25X1

**Contents**

	<i>Page</i>
Summary	iii
Scope Note	vii
The Model Islamic Economic System	1
Spiritual Background	1
Operational Features	1
The Iranian Economy Under the Ayatollah	5
Khomeini's Inability To Satisfy Original Supporters	5
Khomeini as Economic Policy Guide	6
Initial Economic Difficulties and Advantages	7
Secularist Influences	7
The Economic Decision Making Process	8
Economic Impact of War With Iraq	8
Perspective on Gross National Product	9
Situation in Industry	9
Situation in Agriculture	11
Situation in Banking	11
Current State of Consumption	12
Cut in Dollar Earnings	12
Consequences of Economic Pressures	12
Iran as a Half-Formed Islamic Economic System	13
Extent of Implementation of System	13
Prospects for the System After Khomeini	14
 <b>Appendix</b>	
The Iranian Economy Under the Shah	17

**Confidential**  

25X1

**Scope Note**

This report examines the spiritual tenets and operating features of an Islamic economic system, the extent to which revolutionary Iran has adopted such a system, and the likelihood that the Islamic elements in Iran's economy will survive after Khomeini passes from power. The report was prepared under contract by an economist who is a veteran of four decades of college teaching and Federal Government research. Sources of information include books, journal articles, and newspaper accounts dealing with militancy in the Muslim world, the efforts of Muslim religious scholars and young Muslim economists to rethink the nature of an Islamic economic system, and the course of economic developments in Iran, especially since 1970; conversations on Iranian economic conditions with a small number of people who have been in Iran recently; and consultation with Washington-based economic and political analysts who follow events in the Muslim world and particularly in Iran. The views expressed in the report are those of the contractor and not necessarily those of the Central Intelligence Agency.

25X1

**Confidential**

**Confidential**

25X1

**Figure 1**

709120 (B00119) 12-86

25X1

**Confidential**



Confidential

25X1

## The Islamic Economic System and Its Prospects in Iran

25X1

### The Model Islamic Economic System

Muslim economists and religious scholars have written several hundred books and articles since World War II describing the spiritual tenets and operating principles of an Islamic economic system as an alternative to the reigning capitalist and socialist systems. Their discussion has been theoretical and speculative in the absence of a real-life Islamic economy anywhere in the world (with the partial exception of Iran). In some cases, Muslim authors disagree on what the important elements of an Islamic economic system are, such as the extent of private ownership and the degree of clerical control over economic decisions. Western writers, who have typically treated the Third World countries as embryonic capitalist or socialist economies in the process of modernization, are only beginning to assess the feasibility of an Islamic alternative.

### Spiritual Background

According to Islamic theoreticians, the following spiritual tenets form part of the essential environment in which an Islamic economic system would function:

- The primacy of Allah as the all-comprehensive, all-powerful, and all-compassionate Deity, who is the ultimate owner of all economic resources.
- The vice-regency of the spiritual heads of the Islamic community as interpreters of Allah's will, governors of the people, and judges of the overall allocation of economic resources.
- The conformance of economic and all other behavior to the *Sharia* (the corpus of Islamic law made up of the Koran, the sayings of the Prophet Muhammad, and the interpretation of these precepts by the leading schools of religious thought).
- The individual's free will to choose between good and evil and between proper and improper use of the community's productive resources.

- The concept of life as an ever-evolving test of the individual.
- The right of the individual to own private property and his responsibility for the sound management of this property as a trustee of Allah and as a member of the community of believers.
- The choice of this life plus an afterlife as the proper timespan for an individual to consider in maximizing his goals.
- The position of the family as the cornerstone of the social and economic order, with male overseership.

25X1

### Operational Features

#### *Islamic Economy: Subordinate to the Islamic State.*

An Islamic economy would operate as a subsystem of an Islamic state that incorporates the spiritual tenets outlined above. One conservative branch of clerical opinion would place the top religious leaders, as highly respected spiritual monitors of society, outside the day-to-day operations of government. Another opinion calls for a professionally trained clergy to head the state's political mechanism, as in contemporary Iran. The latter condition appears necessary if the religious leaders are to have any practical chance to implement a distinctive Islamic economic system.

25X1

*Private Property: Under Constraints.* A second major feature of an Islamic economy is the private ownership and control of most agricultural, industrial, and commercial property. With the exception of large-scale industrial enterprises, the national banking system, and sizable holdings of minerals and land, productive resources would rest in the hands of individual owners so long as they use their property to promote the Islamic faith and the well-being of their fellow Muslims. A minority of Muslim thinkers,

25X1

Confidential

**Confidential**

---

**Sunni and Shia Approach to Economic Doctrine**

*Sunni and Shia Islam do not differ on the substance of economic doctrine, each emphasizing the authority of the Koran and the teachings of the Prophet. The Sunni clergy, however, tend to take a literal, undeviating interpretation of the scriptures, whereas individual Shia clergymen take more latitude in interpretation and exercise a more activist role in implementing their interpretation.*

---

including some influential radical thinkers, advocate government ownership of all productive resources of any substantial size.

**Community Role: Overall Allocation.** The government—or, more broadly, the religious community—would play an important role in deciding the general allocation of resources, the area of authority left free for private entrepreneurship and administration of economic affairs, and the ways in which the well-to-do would underwrite the care of the poor. The government—at the national, provincial, and local levels—would own key economic enterprises and manage substantial revenues and expenditures. Leaders would consult with their colleagues and the rank and file before taking action.

**Natural Resources: Conservation of Allah's Bounty.** Muslim writers underscore the importance of a nation's natural resources as evidence of Allah's bounty, to be carefully conserved and used for the general benefit. In the case of oil, coal, and other natural wealth, some writers hold that Islamic economic doctrine requires government ownership. Others would accept private ownership but argue that, just as Islamic doctrine forbids interest on money because it does not reflect labor effort or risk, receiving personal income from land is unjustified. Still others would allow income to be collected from land and other resources to the extent that the owner has made improvements. Many writers favor placing an upper limit on the holdings of natural resources by any one individual.

**Labor: Fair Wage for Honest Work.** Islam emphasizes diligent and honest work and the obedience of the worker to his employer. The Islamic code also requires the employer to pay sufficient wages to maintain the worker at a level appropriate to his station and to relieve the worker in time of adversity. The community is responsible for ensuring that each individual has a suitable job at a fair level of remuneration and that adequate arrangements are made for sickness and old age. Muslim writers extol the dignity of labor and subscribe to the principle that the devil finds work for idle hands—at all levels of society.

25X1  
25X1

**Capital: Rights and Obligations.** In an Islamic economy, owners of industrial plant and equipment, farm structures, commercial properties, and other real capital have a right to the surplus of their revenues over the costs of doing business. The man who profits from risking his property in business ventures does not violate Islamic law as long as he deals justly in the marketplace and shares his surplus with the poor. The Islamic code permits the owner to share the risk with others under an agreement dividing profits and losses in an agreed ratio. The owner can also rent real property because the depreciation of the physical facilities justifies a return.

25X1

**Markets: Fair Dealing and Mutual Cooperation.** The market plays a major coordinating role in the Islamic economic system. It sorts out the requirements of buyers and sellers and signals for adjustments in volume and type of output. Neither seller nor buyer should take advantage of the ignorance or poverty of the other. Sellers and buyers receive a constant stream of market information and collectively agree on a fair price. The maintenance of quality standards becomes a moral issue, supported by the community forces of tradition, authority, and reputation and also by the flow of information. Although the market fosters the prompt supply of the right goods through competition, sellers must cooperate with one another in matters of mutual concern. Most Muslim writers believe that the merchants are effective arbiters of supply and demand and that the government cannot

25X1

25X1

25X1

**Confidential**

Confidential

possibly know market details or determine correct prices. A minority, however, distrusts market results and argues that the government should allocate resources and coordinate all economic activities.

**Financing the Economy: Prohibition of Interest.** Perhaps the most dramatic characteristic of an Islamic economy is the prohibition of *riba* (payment or receipt of interest for the loan of funds). In the case of a personal loan of money or goods, a Muslim businessman may not collect more than the principal, since this would be taking advantage of a brother in want. In the case of a business loan, the lender cannot receive interest, since he has neither exerted personal effort nor undergone any risk. Commercial banks, however, may transform themselves into investment banks that advance funds on the basis of sharing profits and losses in an agreed proportion with the user of the funds. Such banks pool the funds of depositors and pay them a fluctuating return based on the profitability of the bank's joint ventures. Risk and administrative costs thus justify the receipt by the bank and the individual of a return above principal.

**Objections to Insurance: Permissible Forms.** Islamic doctrine is hostile toward insurance, alleging that:

- Insurance involves an uncertain return and is to be equated with gambling, which is prohibited in the Koran as socially divisive and disruptive of spiritual life.
- Insurance is unnecessary, since Allah has prescribed mutual aid arrangements (via the family, the mosque, and the employer) to provide for believers.
- Insurance encourages reckless business ventures and fraudulent claims.
- Premiums typically are used by insurance companies to earn interest and to speculate on security markets.
- Insurance has entered the Muslim world because of trade with the West.

Insurance companies in most Muslim countries operate on a low-key basis:

- They do not advertise openly or press potential clients.
- They normally do not insure personal lives or property (Personal lives are in the hands of Allah, not of man).

- They ostensibly avoid investing their funds to earn interest.
- They normally employ a board of religious consultants to make sure their activities conform to Islamic law. 25X1
- They confine their activities largely to traditional forms of business insurance, particularly marine insurance.  25X1

**Providing for Innovation: Low-Key Encouragement.**

The Islamic economic code emphasizes the preservation and enhancement of religious values rather than the discovery of new products and methods of production. Islamic economists believe that, once the faithful have overthrown non-Islamic regimes and established Islamic standards for using and sharing Allah's bounty, the economy will become value-oriented rather than production- or profit-oriented. Investment in new capital plant and production methods would be rejected unless the impact on old plant and methods is mild and the gains from innovation are especially large. The top authorities would reject most innovative development projects involving foreign technicians, and the markets would quietly deal with the flow of business innovation at a lower level.  25X1 25X1

**Preventing Inflation: Conservative Spending.** Muslim writers have little to say about inflation beyond noting that recently inflation has been a worldwide phenomenon attributable to boom-and-bust cycles in capitalist countries. A Muslim writer addressing the problem in an Islamic economic system might argue that several elements would combine to keep prices from rising or at least from rising rapidly:

- Once an Islamic economy is in place, consumer, business, and government spending will be governed by fair market prices, be free of speculation and extravagance, and be conducive to social stability.
- Workers will give an honest day's work for their pay and receive an honest dinar's worth of goods in the marketplace. 25X1
- Loan values will not be inflated by interest.
- The central bank will advance additional funds to the transformed investment banks only if unemployed resources are available for new ventures.
- Friendly Muslim countries will be available as alternative sources of supply in case of shortages.  25X1

Confidential

**Confidential**

**Taxation: Zakat and Other Taxes.** The keystone in the tax system of the model Islamic economy is *zakat*, an annual religious levy on an individual's wealth for the relief of the poor. A modernized *zakat* conceivably would entail a small percentage levy on all wealth above a certain level, paid annually to the religious leader or organization of the believer's choice. The Koran established *zakat* as a tax payable annually on food grains, cattle, and cash after one year's possession. Rates varied—2.5 percent on money and precious metals, 10 percent on grains and fruits from rainfed land, and 5 percent on grains and fruits from irrigated land. The tax originally did not sufficiently distinguish between wealth and income. It eventually became a matter of voluntary charity, with coverage and rates varying widely among Muslim countries. A second traditional religious tax, *khums* (literally, one-fifth) also is discussed in widely varying terms by Muslim writers. The typical description involves a 20-percent tax on an individual's surplus annual income. The writers praise these taxes for restraining the undue accumulation of wealth and providing substantial funds for social welfare. Under an Islamic state, religious taxes would have to be integrated with government taxes on property, income, transactions, and licenses. [ ]

**Consumer Choice: Forbidden Products and Activities.** In an Islamic economic system, the "what is to be produced" would partly depend on the Islamic prescriptions against extravagances and luxuries, particularly at a time when people at the bottom of society lack necessities. Under Islamic law, furthermore, individuals may not traffic in pork, liquor, or lewd reading matter. Among forbidden activities are prostitution, gambling, hoarding, and speculation (cornering the market). In general, Islamic scholars believe that in a truly Islamic economy the "preference schedules" of families and government organizations would differ markedly from their capitalist and socialist counterparts. [ ]

**Technology: Lower Priority.** An Islamic economy places a higher priority on religious duties, human relations, and community values than on numerical output goals, productive efficiency, and modern technology. The Islamic society in some instances would

view the displacement of workers by technological change as too high a price to pay for increased output. Muslim economists are beginning to argue that religious requirements, such as fasting, may increase rather than lower production, for example, by nurturing community solidarity and the work ethic. A further influence on the "how it is to be produced" is the call for indigenous technical innovation to avoid dependence on outside nations for technology, machinery, and spare parts. [ ]

**Distribution of Income: More Equitable.** Muslim writers are uneasy in dealing with the wide disparities of income prevalent in almost all contemporary Muslim countries. If the true spirit of Islam permeated society, they claim, the haves would freely and generously support the have-nots, and inequality in incomes would steadily decline. The forces that encourage a more equitable distribution of income in the model Islamic state include the *zakat* levy, other taxes, private charity, socially enforced obligations for well-to-do individuals to support the extended family, inheritance laws, public welfare measures, pressures against extravagant living, the prohibition on interest, the notion of fair price in the market, and the emphasis on the work ethic. Despite the presence of these forces, the majority of Muslim commentators recognize that substantial differences will continue to exist in personal inheritance, ability, and luck and that Allah distributes his bounty in uneven amounts. A small minority of writers urge complete equality in income distribution. Whatever the blend of income distribution policies, the Islamic economy will exert new and untried pressures in the area of "for whom it is produced," with the outcome highly dependent on the traditions and character of the individual Muslim nation-state and the priorities of its leaders. [ ]

**Women and Non-Muslims: Permanently Low Status.** The economic position of women in the Islamic economy would reflect their general confinement to the household and to custodial, childrearing, and nurturing duties. Certain fields would be open to women such as nursing, teaching (of female students), and obstetrics. Employment in textiles and other light

25X1

25X1

25X1

25X1

**Confidential**

Confidential

industry would be authorized under carefully controlled conditions. Women normally would not practice a profession or serve in high business or political posts. Non-Muslims also would be relegated to second-class status, since society would be monolithic and theocratic in operation. They would lack necessary contacts, mutual supports, and moral sympathy.

**Education: Decisive Arena.** Most Muslim writers hold that the educational arena is decisive in the battle for Islamization. An Islamic economy would allocate substantial resources to education, with priority going to the inculcation of Islamic attitudes and values and less attention to the sciences and humanities. The authorities would purge Western and Eastern cultural influences as soon as possible.

**Population: Increases in Store.** Even though a few Muslim thinkers recognize the necessity of population control through family planning, most Muslim countries almost certainly will pursue policies that reflect existing pronatalist social values rather than antinatalist economic requirements. The fully consolidated Islamic state would encourage marriage, the family, the production of children according to Allah's will, and the support of poor children through the network of charitable institutions. More children mean more of the faithful, more hands to work with the natural resources provided by Allah, and more soldiers to turn back the infidels.

**Foreign Economic Relations: Favoring Muslims.** The Islamic economy would gather momentum more rapidly if launched in a sea of ideologically compatible Islamizing countries. A newly fledged Muslim economy competing in a world of capitalist and socialist states, on the other hand, would remain tied to a system of interest payments, alien technology, and proscribed cultural attitudes. In the latter case, which describes the real world today, the Islamic state would reduce non-Islamic influences by shifting trade to other Muslim nations and would stress the development of indigenous production capacity and technological strength. Leading Muslim thinkers, especially those emphasizing a transnational Islamic community, urge the establishment of noninterest

banking institutions in the Muslim world as a whole, cooperative development projects, and aid to the poorer by the richer Muslim nations.

### The Iranian Economy Under the Ayatollah

In spite of the widespread interest of Muslim writers in establishing an Islamic economic system, the rulers of the 40-odd newly independent Muslim states did not experiment with such a system in the post-World War II era. These rulers, normally educated in foreign schools, faced internal political struggles or ethnic conflicts that demanded their immediate attention. Furthermore, they often depended on international capitalist markets for machinery, military equipment, and technology. In Iran, however, Western orientation suddenly gave way to fundamentalist Islamic values in the revolution of 1979.

### Khomeini's Inability To Satisfy Original Supporters

Most of the Iranian people greeted the assumption of supreme political power by Ayatollah Ruhollah Khomeini with genuine enthusiasm. The different social groups, however, had accumulated widely varying grievances against the Shah and had drawn up mutually incompatible blueprints for the postrevolutionary society. Some groups envisioned a devoutly religious society, others a pluralistic secular society. Some believed in government ownership of economic resources, others in private ownership. No matter what political path the Ayatollah decided to take, the majority of those who had joined in dismantling the Shah's regime would end up with little to show for the revolution:

- The *intellectuals*, who wanted a humanistic regime, open elections, and a free play of ideas, discovered that the Ayatollah envisioned a strict religious society that brooked no humanistic nonsense and no opposition political parties. As put by one pair of commentators: "From the very early days of the Islamic regime, the religious leaders chose to silence the intellectual community by attacking its dignity and credibility."

Confidential

**Confidential**

- The *technocrats*, who looked forward to rational leadership by engineers, economists, lawyers, educators, and professional managers, lost out in the competition for top posts to clerical and radical forces, whose members had manned the forward trenches during the revolution. The moderate President Abol Hasan Bani-Sadr, elected in January 1980 before the hardline clerics had consolidated their political position, fell from power in June 1981 as part of the growing ascendancy of the clerical ideologues. The bulk of the technocrats shared secular middle-class attitudes and even pro-Western sympathies with many other Iranians. They favored a prosperous and trouble-free life with a good educational system for their children that provides desk jobs with the government.
- *Islamic Marxist guerrillas*, the Mujahedin, who had waged underground war against the Shah, were savagely repressed in mid-1981 (5,000 to 10,000 executions) after they openly challenged the Ayatollah.
- *The Communists* (Tudeh Party) failed in their attempt to capture the revolution and have been pushed back underground by the regime's security forces.
- *Labor leaders*, who had struggled for the establishment of free unions, stood helplessly by as the revolutionaries forced workers into Islamic associations in the factories. The lot of the worker became an amalgam of daily prayer, exhortations to work hard, and declining real wages.
- *Conservative clergy*, who wanted to restrict the mullahs to a spiritual advisory role in the new regime, were overruled in favor of a highly activist policy of direct rule.
- *Socialist-minded clergy*, attracted to leftist doctrines of widespread government ownership of land and other productive property, are still struggling against fellow clergy and rich laity who cite the Koranic support of private property.
- *Kurdish and other ethnic leaders*, seeing in the political disorder an opportunity for greater regional autonomy, were held in check by the Ayatollah's newly formed Revolutionary Guard.
- *Women* (especially women from well-to-do families), who had had a taste of modern education, responsible jobs, and personal freedom, were removed from judgeships and other top posts and pressed to return to the household.

25X1

The Ayatollah's domination of the political scene originally rested on his personal popularity and the widespread opposition to the rule of the Shah. As a consequence of the shattering of the anti-Shah coalition, Khomeini's power by mid-1986 rested mainly on his own stern will and three instruments of raw power—the fundamentalist clergy, the mosque-based security and support system, and the Revolutionary Guard.

25X1

#### **Khomeini as Economic Policy Guide**

For Ayatollah Khomeini, the inculcation of Islamic spiritual values, the beating back of internal political challenges, and the conduct of the war against secularist Iraq take precedence over economic issues. Khomeini seems little disposed to get into the details of economic affairs. His reluctance stems in large measure from his aloof managerial style, which consists in letting issues bubble for a while before he comes to a final decision. This style allows issues to be aired among subordinates, conserves the Ayatollah's limited physical strength, and confirms his position above the battle and his ultimate authority over all matters of consequence.

25X1

Although not his own economic minister, Khomeini has adhered to certain general views on economic affairs within the Islamic republic:

- Iran must be as self-sufficient as possible, relying on its own agriculture, industry, and technological know-how rather than on imports and foreign experts.

**Confidential**

**Confidential**

- The organizational unit must be much smaller both in agriculture and industry, that is, there are to be no more giant agribusinesses or industrial trusts.
- Instead of putting technology ahead of other values, the revolutionary economy must slow the introduction of complex production methods, especially those that require the import of foreign equipment and the employment of foreign experts.
- The community's standards for taking care of the poor must be raised.
- Oil must play a lesser role in the Iranian economy, both to conserve Allah's bounty and to reduce dependence on dealings with the non-Muslim world.
- The Ayatollah apparently has taken an intermediate position in the dispute among the Iranian clerics as to whether private ownership of productive property should prevail (the view of the majority of clerics) or whether government ownership of productive property should be the norm (the minority view).
- In other matters, the Ayatollah's views parallel the usual guidelines for the Islamic economic system.

#### **Initial Economic Difficulties and Advantages**

Because of demonstrations, strikes, and shutdowns the urban economy was in disarray when the Ayatollah took charge. Tens of thousands of businessmen and property owners had fled the country. Many others had closed their businesses because of a lack of goods and public disorder. Mobs in Tehran had seized government offices, the police stations, and the Army barracks. Many local revolutionary groups were running amok, arresting and killing people.

The Khomeini regime filled this vacuum of authority with remarkable speed, considering the size and complexity of the issues:

- It sponsored new revolutionary institutions, such as the Islamic Republic Party, the Revolutionary Guard, the Hezbollahi (enforcement squads), and the revolutionary courts.
- It replaced hundreds of bureaucrats, factory managers, and military officers deemed loyal to the Shah.

- It set up rationing and distribution systems for basic commodities in urban areas, using a combination of government bureaus and the mosque-based neighborhood komitehs (revolutionary committees).
- It forced reluctant businessmen to open shops and factories that had been shut down.
- It facilitated the recovery of oil production to roughly half the level under the Shah.
- It began what is proving to be the long-drawn-out process of settling land distribution cases that had resulted from both the Shah's land reform and the flight of landowners.

As to initial economic advantages, the Ayatollah came to power on a wave of revolutionary excitement and could call on the nation for material sacrifices. The new regime inherited accumulated foreign reserves of roughly \$20 billion and—above all—a large, well-developed oil industry that Iranians could operate with diminishing outside help. The loss of several hundred thousand well-to-do people through emigration could be counted a blessing in a nation that might need to trim its consumption to spartan levels. The simple lifestyle of Khomeini set a politically useful example in contrast to the opulent lifestyle of the Shah and his associates.

#### **Secularist Influences**

Tens of thousands of Iran's professional and managerial people had studied in Western Europe or the United States and had absorbed secularist views of science, history, economics, and politics. New battalions of Iranian students have been sent abroad to these "satanic" centers during the Ayatollah's rule. The Ayatollah consequently has been experiencing the same "red-versus-expert" dilemma that has plagued the USSR, China, and Eastern Europe throughout the postwar period. The students who return to Iran often are carriers of non-Islamic values. A sizable number support the Ayatollah's transformation of society passively, adhering to Khomeini's brand of Islam only outwardly. A small number infect society ideologically and could even endanger the revolution in conjunction with other forces, especially after Khomeini passes from power.

25X1

25X1  
25X1

25X1

25X1

**Confidential**

**Confidential****The Economic Decision Making Process**

Under the Ayatollah's rule, the economic decision making process in Iran remains a shifting mixture of capitalist, socialist, and traditional elements, but with a strong and increasing Islamic overlay. [ ]

Although medium- and small-scale capitalist owners, except for the Shah's supporters, have retained the bulk of their agricultural, industrial, and commercial property, they must act in an Islamic fashion: giving up the old financial system of interest payments and receipts; keeping unneeded workers on the payroll; paying more taxes and responding to the host of "voluntary" collections for the war effort; dealing under growing restraints in the marketplace with respect to price and quality of goods; and avoiding extravagance in their own lives, at least in public. [ ]

Socialist planners and managers likewise have Islamic obligations to see that Allah's bounty of natural resources is carefully guarded, conduct the operations of large government enterprises in support of Islamic objectives, arrange for widespread relief of the poor, remold the educational system along Islamic lines, and root out forbidden products and economic activities. These planners and managers face difficult short-term economic decisions in mobilizing resources for a major war at a time of declining national output.

[ ]

Traditional elements still play an important role in Iranian economic society, and some of these elements get strong support from the Islamic code: the influence of the mullahs, the bazaaris, and the heads of households in local affairs; the daily prayers and the religious holidays that are woven into the schedule of economic life; the poor tax, almsgiving, and other community measures that help the needy; and the limitations placed on women's role outside the family.

[ ]

Economic planning under the Ayatollah has suffered from serious disabilities, many the same as under the Shah:

- The presence of a strong-minded leader at the top whose economic decisions reflect military, political, and religious factors and override economic plans constructed by planning and budget technicians.

- The existence of a complex pattern of authority, including important new revolutionary organizations, which largely precludes disciplined use of scarce resources under an internally consistent economic plan.

25X1

- A lack of trained and experienced planners and the absence of reliable statistics.
- Uncertainty as to the availability of raw materials and spare parts.
- A substantial increase in shortages and black marketing, coupled with inflation and the near exhaustion of foreign exchange reserves. [ ]

25X1

Households, business firms, and government offices do little planning beyond the needs of the moment. People eat, crops grow, oil is lifted, and the Army fights—all without the benefit of the coherent economic planning that makes a substantial difference in how leaders think and resources move. The economy simply goes on because of its resourceful bazaari businessmen, its residuum of Western-trained technocrats, its improvising rank and file, its bribable authorities, and its traditions of localized decisionmaking. Iranians have long had to live by wheeling and dealing, and they do it well. [ ]

25X1

25X1

25X1

**Economic Impact of War With Iraq**

The cost in human and material resources of the Iran-Iraq war has been enormous:

- Approximately 300,000 Iranian soldiers killed and perhaps twice that number wounded (Iraq, with one-third the population of Iran, has suffered roughly one-third as many casualties).
- The destruction of industry and housing in a populous section of Iran and the import of \$3-4 billion annually of weapons, spare parts, and war supplies, often bought at premium prices.
- The domestic cost, in the neighborhood of \$10-15 billion annually, of provisioning, arming, and transporting the armed forces and of caring for the wounded and refugees. [ ]

25X1

25X1

The ability of the Khomeini government to wage a war of this magnitude and at the same time deal with its internal enemies and with the dislocations in

**Confidential**



Confidential

the international oil market testifies to the great strength and staying power of the Ayatollah and his regime, as well as to the economic and financial legacy from the Shah. [ ]

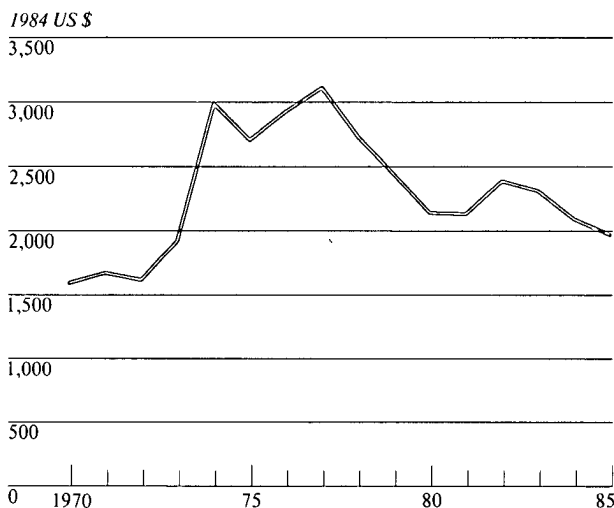
The main economic costs of the war have been a curtailment in investment, with a consequent deterioration in industrial and agricultural capacity, and a sharp fall in foreign exchange reserves. The abandonment or indefinite postponement of some grandiose projects sponsored by the Shah has had little short-term consequence. What has hurt most has been the failure to obtain machinery for completing useful new industrial plants and upgrading oil installations; the spare parts and the raw materials to keep existing industrial facilities in full operation; and the machinery, chemicals, and seeds needed if agricultural output is to keep pace with population growth. [ ]

The central government has lacked sufficient managerial skills and the information system needed to effectively conduct a large-scale war on top of its other obligations. Consequently, local organizations and families have taken care of a substantial part of the provisioning, transport, and medical care of the soldiers, a further testimony to the resiliency of the underlying economy. [ ]

#### Perspective on Gross National Product

Rough calculations for the Iranian GNP from 1970 to 1985 reflect the great rise in GNP in the last years of the Shah's reign and the falloff in the economy under the Ayatollah attributable to the war, the decline in oil revenues, and the confused management of economic affairs. The year 1977 marked the peak of prerevolutionary GNP. Production in 1978, the last full year of the Shah's reign, suffered from widespread strikes and riots. Under the Shah in the 1970s, per capita output doubled from about \$1,500 to \$3,000. Under the Ayatollah, per capita output has fallen from \$3,000 to \$2,000. Population has grown at an estimated annual average rate of 3 percent over the entire period since the revolution, [ ] the rate has started to climb toward 3.5 percent because of the pronatalist stance of the Khomeini government. [ ]

**Figure 2**  
**Iran: Per Capita GNP, 1970-85**



311268 12-86

#### Situation in Industry

As of mid-1986, industry continues to suffer from the confusion of managerial authority under the revolution, lack of raw materials and spare parts, and worker inefficiency. Iran still feels the loss of half or more of its managerial and professional talent, even though the hastily mustered managers of the first months of the revolutionary regime have had seven years of experience. Much of the trouble in industry stems from the continued mismatch of responsibility and authority. Representatives of the new revolutionary organizations have acquired a vested interest in wielding power at the factory level. Zealous young Revolutionary Guards, for example, monitor attitudes and behavior in industrial plants. Even if he enjoyed complete authority, the factory manager could improvise only so much in the face of power outages, raw material shortages, and the absence of necessary

Confidential

**Confidential**

---

**Iran: Basic Facts****Strategic location:** massive Middle Eastern landbridge**Area:** 1.6 million square kilometers**Climate:** hot and arid in central plateau; colder and wetter in rimlands**Population:** 46 million (mid-1986), growing at 3.1 percent per year**Ethnic groups:** Persian, 62 percent; other Iranian, 13 percent; Turkic, 18 percent; other, 7 percent**Religion:** Shiite Islam (93 percent)**Arable land:** 16 percent of land area**Mineral wealth:** oil, iron ore, coal, copper, lead, zinc, limestone**Key postwar events:** decline of British influence, huge oil wealth, fall of Shah (1979)**Focus of energies:** extremely bloody war with Iraq, now in seventh year**Form of government:** theocracy; militant Islamic rule**Head of government:** Ayatollah Ruhollah Khomeini, born 24 September 1902**Capital city:** Tehran; growth from 5 million to 9 million people since 1978**Political alignment:** "Neither East nor West" but Islamic**Economic system:** partly developed Islamic economic system**Public ownership:** banks, major industry, transport, and communications**Private ownership:** agriculture, lesser industry, handicrafts, commerce**Government planning:** wartime economic planning; poor statistics**Rationing:** basic necessities; endemic shortages**Role of market:** pervasive at microeconomic level; includes black market**Economic membership:** OPEC, IMF, World Bank, G-77**Special features:** prohibition of interest; religious duty to support needy**Industry:** oil, war goods, textiles, construction materials, foodstuffs**Agriculture:** wheat, barley, sugar, beets, rice, cotton, livestock, dates**Exports:** \$15.6 billion (1985), approximately 95 percent oil**Imports:** \$15.7 billion (1985); foodstuffs, war goods, machinery, services**Major trade partners:** Western Europe, Turkey, Japan**GNP:** approximately \$90 billion (1985), or \$2,000 per capita**GNP trend:** downward drift as capital plant wears out because of war**Basic economic problems:** cost of war; decline in oil revenues**Inflation:** caused by wartime shortages; roughly 20 percent per year**Unemployment:** 30 to 35 percent; because of the lack of raw materials and capital plant 

spare parts. Furthermore, much of the support structure for industry—in finance, transport, communications, training, and utilities—operates well below prerevolutionary standards. The government encourages people to reopen old businesses or to start new ones but fails to provide the proper setting. The case of an entrepreneur who opened a chicken factory in a provincial capital illustrates the hazards. Because of shortages of fuel and imported feeds, the chickens

sickened and died, and the business failed. Potential entrepreneurs understandably shun the hassles of factory ownership and invest their money in trading enterprises, notably import businesses.

Existing industrial plant typically operates at 40 percent below capacity. Net industrial capital formation almost certainly is negative, that is, the deterioration of old capacity exceeds the completion of new

**Confidential**

Confidential

facilities. Quality of output has been low since the onset of the revolution and, according to most observers, has been falling still lower. Workers, whose real pay continues to drop because of inflation and the drop in per capita output, have little motivation to increase production or to restore quality. [ ]

Firm aggregate statistics on the decline in industrial capacity, output, and discipline are not available. The observer, however, benefits from some fairly good statistical series, for example, in oil and from first-hand information about specific problems. In January 1986, for example, Minister of Heavy Industries Behzad Nabavi told a seminar on industrial planning and budgeting of the need to improve worker discipline and productivity. Nabavi had found at one truck plant that a worker had a quota of spraying undercoating on 60 trucks a day when it took only 70 seconds to spray each truck. In another case he discovered workers had increased the amperage of welding torches to speed up their work, with the result that they burned holes in the aluminum material. In a third plant he found workers cooking breakfast at 0800, taking a break at 0900, working at 1000, knocking off for prayer at 1100, and putting in a total of two hours' work for the whole day. [ ]

#### **Situation in Agriculture**

The severe natural limitations on output in Iran's agricultural sector continue to limit production. Rain-fall not only is scanty in most of the country but also varies from season to season and year to year. Farmers over past generations have already brought into use the good land suitable for cultivation. Troubles in domestic industry and the decline in Iran's ability to purchase foreign fertilizers, agricultural chemicals, and farm machinery have also held back the expansion of capacity and output. Further, the regime has failed to resolve the question of land tenure in the countryside. Production of major crops has held fairly steady over the past several years, discounting for weather variations. This is not good enough, given the 3-percent annual growth in population and the government's provision of more food to the poor. As in most developing countries, the building of new factories, roads, and dwellings has increased the competition for scarce agricultural land. Two important positive factors have been increases in government

procurement prices for some farm products and fairer treatment of rural families in the distribution of scarce consumer goods. [ ]

#### **Situation in Banking**

The revolutionary government has nationalized the commercial banking system and has consolidated all commercial banks into four major banks with numerous branches. These banks supply funds for the industrial and agricultural enterprises now in government hands and for individual borrowers. The banks have no theoretical limit on the amount of credit they can extend so long as the Iranian central bank authorizes the expansion and stands ready to issue more money. The inefficiencies of government enterprises, the growing shortages of goods, and the constant struggle of Iranians to minimize the fall in their living standards all contribute to the high inflation rate, estimated at anywhere from 15 to 30 percent or more and in this paper assumed to be approximately 20 percent. [ ]

Businessmen and travelers who need dollars to travel abroad can no longer get even small amounts from the government, whose holdings are down to minimum transaction requirements. They have recourse, however, to a brisk private market for foreign funds in which dollars can be bought for about 650 rials each—seven or eight times the official exchange rate. Financial representatives of bazaari businessmen hawk foreign currencies in front of major banking offices, notably in Tehran. After an agreement, both buyer and seller enter the bank where the purchaser's passport will be stamped authorizing his taking out the specified sum (ranging up to \$5,000). To obtain larger amounts, for example, in order to pay for a student's Western education or a businessman's foreign purchases, a buyer may make a deal with the bazaari businessman himself, transferring an Iranian property for a nominal sum in rials plus the delivery of some dollars abroad. The supply of dollars in this market comes from the billions of dollars in Iranian accounts in Western banks. In the few months before the fall of the Shah, Iranians added more than \$1 billion to these accounts. The government tolerates the transactions as an economic necessity. [ ]

25X1

25X1

25X1

25X1

25X1

Confidential

**Confidential**

The nationalized banking system conforms on the surface to the strict Islamic prohibition against interest. The banks supply funds to enterprises under profit-sharing agreements, and depositors receive (say) 7 percent on short-term and 9 percent on long-term deposits under the guise of a return from an investment pool organized by the bank. Meanwhile, the banks continue to perform normal commercial services for the customers: routing checks, handling bills of lading, and so on. The banks serve as the government's financial agent in this era of widespread nationalization and regulation of economic activity.

#### **Current State of Consumption**

The regime has succeeded in providing the population with at least a minimum amount of necessities in both urban and rural areas. Basic foodstuffs and household goods have been furnished at low official prices. The gradual increase in recent years of shortages of goods, even of rationed quantities, reflects the pronounced decline in per capita national economic output, the near exhaustion of foreign exchange reserves, and the heavy burden of war.

Despite unemployment of 30 to 35 percent and low real wages, people in the cities and towns seem to have money. This is both a reason for and a result of the virulent inflation and the flourishing black market. The government's war expenditures and its limited ability to collect taxes also help explain the apparent abundance of money.

Because of the rapid growth of population, consumption is even more clearly shrinking on a per capita basis. The most critical area probably is urban housing, which is extremely crowded because of the continuing large-scale migration of people from the countryside, perhaps averaging more than 1 million people a year, the necessity to take care of 2 million war refugees, and shortages of construction materials and skilled labor. The quantity of water available in big cities has increasingly fallen short of the needs of the people. In some cases, the quality has badly deteriorated because of inadequate supplies of pipes, pumps, chemicals, and skilled personnel. Shortages of electricity in both cities and the countryside are endemic.

Measures to improve the supply of consumer goods and services falter because of the necessity to prosecute the war, the decrease in investment resources, and the reduction in funds available to import foodstuffs. Managerial failures have hampered efforts to rebuild areas devastated in the war and to move the refugees back to their homes.

As for the relation of inflation to consumption, the government seeks to stabilize the prices of rationed goods, while accepting rapid rises in the prices of luxury goods and above-ration quantities of basic goods. This policy requires constantly increasing budgetary subsidies to support the rationing system. Unfortunately for the authorities, the policy results in a growing differential between the ration price and the market price and hence an increased incentive to divert supplies from ration channels and to bribe people who control supplies. The more severe the shortages of goods, the stronger these tendencies are.

#### **Cut in Dollar Earnings**

If oil prices received by Gulf producers continue to average \$13 per barrel, as in March-April 1986, Iran's earnings from oil will be cut from roughly \$15 billion in 1985 to \$9 billion in 1986. Each previous reduction in Iran's national income has bitten into increasingly important areas of spending. By now, accumulated foreign exchange holdings—approximately \$20 billion when Khomeini took over—are down to the minimum level of about \$3 billion deemed necessary for transaction purposes. The revolutionary regime has made a point of not going into debt to foreign suppliers, but in early 1986 it apparently was arranging to lengthen payment terms from 180 to 360 days on some types of transactions.

#### **Consequences of Economic Pressures**

The Iranian economic system under the Ayatollah has had to accommodate the enormous burden of a war whose tactics and casualties warrant comparison with World War I. The economy regained some of its strength in 1982 and 1983 with the partial restoration of oil production and sales at \$26 to 28 per barrel.

**Confidential**

Confidential

Subsequently, increased shortages and continued deterioration of capital plant have caused national output to sag, most clearly on a per capita basis. The recent precipitous fall in oil prices, unless soon reversed, cost Iran a further \$6 billion in foreign exchange in 1986 at a time when its economic maneuvering room had been perceptibly narrowed. The anticipated cuts in foreign exchange earnings will add to consumption blues and hamper Iran's ability to exploit its military successes of early 1986. The differential between official government prices and black-market prices continues to widen. The percentage of imports coming into Iran through illicit channels is rising, and growing shortages encourage the diversion of even more industrial and consumer goods to the black market. The range of possible government countermeasures or temporizing actions is narrowing. [ ]

#### Iran as a Half-Formed Islamic Economic System

The spiritual environment necessary for an Islamic economic system exists at the top level of leadership in Iran today and among the great masses of people, but many members of the technical and managerial class have only a superficial dedication to these values. Ayatollah Khomeini, who dominates the Iranian nation-state under its revolutionary constitution and by virtue of his own strength of character, has seen to it that able clerical supporters fill the most important posts in the government. Yet the economy carries on only because of the efforts of tens of thousands of secular technocrats and businessmen in the ranks below the clerical rulers. Moreover, the time-honored requirements for making a living and acquiring wealth give way only grudgingly to Islamic precepts governing economic behavior. [ ]

#### Extent of Implementation of System

Two main features of the Islamic economic system are in place in Iran today: the subordination of economic goals to religious values and the position of the economic system as a subsystem of the Islamic republic. Their practical impact on the lower levels of the system are continuously undercut by the exigencies of the war with Iraq; the dependence on the

outside capitalist oil market; and the existence of secularly minded professional and technical people, some of whom resent being made scapegoats for economic misjudgments and chafe under the interference of revolutionaries in daily business affairs. [ ]

Khomeini has not taken a strong position on the question of private property, which has Koranic backing as a means of working Allah's will through trusteeship and as a practical means of eliciting hard work. The minority who take the leftist path of almost universal government ownership have found themselves blocked by a conservative majority of clerics who themselves, or their key backers, frequently are large landholders or businessmen. [ ]

The Ayatollah's government has nationalized Iran's heavy industrial plants, banks, and major transport lines. The government almost certainly will continue to operate the banks, oil facilities, and major transport lines. Over the long run, it probably will encourage private investment in and operation of many of the nonoil industrial facilities now in government hands. [ ]

Private economic activity dominates the middle and lower reaches of the Iranian economy, embracing most of light industry and agriculture, handicrafts, and local commerce. As shortages have mounted and foreign exchange has become scarcer, more private activity has moved outside officially sanctioned channels. Dealings in the marketplace exhibit the rough-and-tumble characteristics of an older Iran more than the Islamic ideals of fair market conduct. [ ]

Managers of factories, large merchants, owners of market stalls, and people everywhere feel a gradual increase in financial exactions and intervention into their affairs by the Islamic revolutionary organizations. As has happened in other revolutions, many of the new local authorities have become corrupted by power. The increase in payoffs and black marketing in Iran today is in stark contrast to the Islamic economic model, under which clerical influence would be unified and benign. [ ]

Confidential

**Confidential**

Other features of the present-day Iranian economy fail to match the idealized features of the model:

- One-fifth of the labor force is unemployed even though under the model Islamic economy each individual is guaranteed work that will nurture his God-given talents.
- Resources are wasted because of the ineffectiveness of economic planning, although the waste of Allah's bounty is especially condemned in Muslim writings.
- The slow work pace and low quality of output reflect a tendency to encourage "revolutionary" rather than productive activity, whereas Islamic precepts require that the laborer gives an honest day's work to an employer who in turn is concerned with the worker's health and welfare. [ ]

Government authorities have banned the payment and receipt of interest in accordance with Islamic doctrine. Yet the reorganized banks continue to charge interest to business enterprises and to pay interest to depositors under the fiction of a return on risky investments. Private lending—under some other name—no doubt continues, the interest rates presumably reflecting the high degree of risk and the high rate of inflation. [ ]

The rationing of basic consumer goods through government offices and mosque-based komitehs constitutes the bedrock of government policy for aiding the poor as required by the Islamic model. The payment of *zakat* (the alms tax on wealth) is voluntary, and only a fraction of the people honor this religious obligation. Ad hoc collections for the support of the armed forces, the relief of refugees, and assistance to the wounded are numerous and cannot be avoided. A merchant may have to give up a fraction of his stock, a truck owner may have to carry provisions to the front, or a passerby in a downtown street may have to contribute. [ ]

The revolutionary regime has enforced the provisions of the Islamic code that prohibit certain types of consumer goods and social practices. Drinking liquor, prostitution, and abortion are among the prohibited

activities, and offenders are severely punished if caught. A considerable amount of drinking and high living continues in private. [ ]

Trade has shifted perceptibly toward Third World countries, including other Muslim states. Iran, however, still relies heavily on the Western world for modern machinery and technology, and the great bulk of its oil still goes to industrial countries. [ ]

The Ayatollah has removed women from judgeships and other top positions and has tried to force the several hundred thousand women in urban jobs back into the household. He has failed to eliminate them from the work force, however, because of their resistance, the need for their skills, and the drain of skilled males into the armed forces. He has conceded the use of women in education, nursing, and obstetrics. [ ]

#### **Prospects for the System After Khomeini**

The Islamic economic system has reached its high water mark under the Ayatollah. After his departure and the end of the war, any efforts to advance the system most likely will give way to the practical requirements of an oil-based developing economy with major capitalist customers and suppliers. Iran, with its long tradition of private ownership and trade and its still huge oil wealth, will follow the capitalist model if its business interests have their way. Yet government ownership and regulation will continue to play a large role. Post-Khomeini Iran will possess not only a large bureaucracy inherited from the Shah's regime but also the sizable numbers of offices added in the new revolutionary organizations. [ ]

The Ayatollah—constrained by war, falling oil revenues, and a secularist fifth column—has introduced many of the conditions needed for establishing an Islamic economic system while failing to introduce full-blown Islamic features into day-to-day economic affairs. He lacks the resources, the popular support, and the time to complete the shaping of his half-formed Islamic economic system into an unalloyed Islamic system. Even the end of the war with Iraq will not allow Iran to construct a full-blown Islamic economic system because of the high cost in popular

25X1

25X1

25X1

25X1

25X1

25X1

**Confidential**

**Confidential**

disaffection and economic efficiency, the lack of support from other countries, and the difficulty of promoting the system in a secular, high-technology world. [REDACTED]

25X1

The revolutionary government cannot conduct the war, produce and market oil, or provide for its rapidly growing population without recourse to Western markets and goods. As the bloody war moves into its seventh year and living standards and morale continue to sag, the rage against the Shah is losing some of its fervor, and the incompatibility of most people's aspirations with the Ayatollah's bellicose policies is becoming clearer. [REDACTED]

25X1

Iran's need for links to Western markets and goods refuses to disappear. The dilution of Iran's Islamic society with Western influences persists, and the rulers of the other Muslim countries continue to promote an ersatz brand of Islam that, the militants charge, is more detrimental to the faith than the rule of the colonialists. [REDACTED]

25X1

The mullahs (clergymen) at the top realize that a loss in economic control leads almost inevitably to a decline in political power. In the absence of Khomeini's unifying authority, however, they will possess considerably less control over factionalism and personal ambition in their ranks, and they will face the desire of businessmen to run their own show and the wish of the populace to return to quiet everyday life. This diminution of authority will take unpredictable forms. Almost certainly the general result will be a decline in prospects for the completion of an Islamic economic system. [REDACTED]

25X1

**Confidential**

Confidential

## Appendix

### The Iranian Economy Under the Shah

Iran emerged after World War II as a large, populous Muslim nation with rich oil and gas resources; a landlord-dominated peasant economy; a merchant-dominated urban economy; an enormous, often inefficient or venal bureaucracy confined largely to Tehran and the oil region; and a highly inequitable distribution of income and an unfairly administered tax system. Iran was an important Third World country in a region whose low-cost energy helped propel the unprecedented postwar economic growth of Western Europe, Japan, and the United States. [ ]

Once the Shah had ousted the nationalist Prime Minister Mohammad Mossadegh in August 1953 and had begun to rule rather than reign, he embarked on a large-scale modernization program that, a quarter of a century later, was to contribute to his spectacular downfall. The program, dubbed "the white revolution," aimed at a rapid buildup of modern industrial facilities, land reform and the technical transformation of agriculture, universal literacy and the training of tens of thousands of technical and administrative specialists at foreign universities, and the creation of powerful military forces. The quadrupling of international oil prices from 1973 to 1974, together with the boosting of Iranian output to 6 million barrels per day (fourth largest after the USSR, the United States, and Saudi Arabia), provided the necessary financial backing. [ ]

#### Agriculture Under the Shah

The ownership and operation of farmland in Iran reflected the highly unequal distribution of political and economic power in the countryside. According to the official estimates of 1951:

- Less than 0.5 percent of the population owned 56 percent of the land under cultivation.
- Between 14 and 20 percent was owned by peasant proprietors.
- Some 15 to 25 percent consisted of *waqf* (religious trust) properties.
- Public domain and crown lands each made up about 5 percent. [ ]

Thus, most of the land was in the form of large estates worked by the proprietor himself, tenants, sharecroppers, and farm laborers. Peasant-owned properties, mostly small in size, were worked by the owner, perhaps with the help of farm laborers at peak seasons. *Waqf* properties could be leased or sharecropped under a resident manager. The concentration of landholdings reflected past grants of land by Iran's rulers, bequests to religious bodies, and purchases by the rich. The high cost of irrigation facilities in this dry country often put the small owner at a special disadvantage. [ ]

25X1  
25X1

The Shah's land reform of the 1960s aimed at breaking up large estates through the sale of sizable portions to tenants, sharecroppers, and village cooperatives, with the government regulating and subsidizing the purchase price. The program substantially reduced the absolute power of the landowner while not ending his dominance in many aspects of rural life; greatly increased the role of the central government in agriculture; did practically nothing to help the majority of landless farmworkers; did little in practice to raise the economic status of the former tenant and sharecropper, who still faced a hard life of subsistence farming, but markedly improved their social, legal, and political status; and disturbed time-honored landlord-peasant arrangements that had reflected the realities of irrigation patterns, economies of scale, and credit arrangements in the countryside. Landlords took advantage of the exceptions and loopholes in the land reform laws, for example, by transferring properties to relatives, but the government generally prevailed over landlord opposition, a major illustration of the great political power of the Shah. [ ]

25X1

25X1

The Shah's agriculture program also called for the establishment of modern agribusinesses, sizable enterprises that were to level land, build roads, improve irrigation, bring in fertilizers, and otherwise lead the

25X1

Confidential



**Confidential**

transformation of the stagnant farm sector. This long-term program had gotten off to a shaky start because of heavy infrastructure costs and the general overcommitment of the economy when it was brought to a halt in 1979 by the revolution. [ ]

Meanwhile, the rapid growth of population, combined with the dislocations attributable to the new patterns of rural ownership and control, led to the migration of millions of people to the cities. Not only was the population getting too large for domestic agriculture to feed, but the standards of consumption were also rising rapidly because of the oil-fueled boom. [ ]

### **Industry Under the Shah**

The key to the Shah's modernization program was the influx of oil revenues that put at the government's disposal tens of billions of dollars with which to buy foreign industrial equipment and expertise. The government-owned National Iranian Oil Company (NIOC) entered into an agreement with an international oil consortium in October 1954 on the production and marketing of Iranian oil. With the rising expertise of Iran's oil personnel, the growth in OPEC influence, and the quadrupling of international oil prices from 1973 to 1974, NIOC gradually became master of all phases of the oil business in Iran. Parallel to programs for expanding the production and refining facilities in oil were programs to exploit the country's large natural gas reserves. [ ]

Oil revenues permitted an acceleration of growth in other branches of industry, which had long dwelt in the shadow of oil. The government poured large sums into the exploitation of iron ore, copper, lead, zinc, and other mineral resources. For example, it allotted \$450 million for a 20-year project to develop copper ore near Kerman. [ ]

The government also moved to end the shortage of electric power for industry and to extend transmission lines in rural areas. Even so, the expansion of industrial and household demand was so rapid that brownouts and blackouts occurred frequently by the mid-1970s. [ ]

The broad aims of the Shah's government were the establishment of an industrial base featuring modern technology and the ultimate capacity to produce

industrial material and equipment then being imported. A series of five-year plans called for rapid increases in the output of steel, copper, aluminum, petrochemicals, and other major materials, with machinery to follow as quickly as feasible. Rates of growth were so high and the influx of oil funds so great that the economy could not easily digest the mounting volume of industrial activity. Money was considered the cure for all problems, whereas in reality the economy lacked the managerial know-how, the skilled labor, the industrial capacity, and the transportation facilities to support the rapid growth set forth in government economic plans. Furthermore, the Shah disrupted economic plans and budgets by insisting on going ahead with his own grandiose projects that stripped more useful projects of resources. In the mid-1970s ships sometimes had to wait several weeks to discharge their cargo, and major industrial plants suffered from such severe shortages of raw materials that a third or more of their labor force was redundant. [ ]

Despite rapid increases in capacity, output, and technological skill, the nonoil branches of industry could not fill domestic demand, let alone generate sizable exports against the day when the oil ran out. [ ]

### **The Shah's Economic System**

Like most rulers in the newly freed Third World, the Shah inherited a traditional economy with a subsistence agriculture, a low-technology light industry, and a dependence on Western countries for advanced equipment and technical training. But, unlike the majority of other rulers, the Shah commanded enormous oil revenues. He regarded these revenues not as the receipts of a centralized bureaucratic state, but as the revenues of an absolute monarch to be distributed at his whim in directions he deemed good for himself and his monarchy. [ ]

At the same time, the Shah was a valued and trusted ally of the United States and a major beneficiary of US economic and military technology. The Iranian nation-state played a leading role in an important sector of the then US-dominated international market system. The Shah had far fewer economic dealings with the USSR and its East European allies. [ ]

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

**Confidential**

Within Iran, the bulk of local economic activity continued under the auspices of traditional markets—a system of premodern capitalism laced with unique cultural influences. The millions of rural family households produced much of what they consumed or met the remainder of their needs mainly from local sources. They sold their labor services and products to local buyers. In areas near cities, traditional landlord-peasant arrangements were changing to market-dominated or government-decreed patterns. In outlying ethnic areas immediately after World War II perhaps one-fourth of Iran's population led a nomadic, pastoral existence, an economic form even older than the landlord-peasant arrangements. As part of the centralization of political power in Tehran, the Shah's government appreciably increased the state's control over these nomads, and they gradually adopted a more settled way of life. [ ]

Under the Shah, most external economic activities and small-scale internal activities were brokered through the market system, whereas large-scale internal activities were conducted largely as state economic ventures and/or entrepreneurial ventures by the Shah and his associates. His economic system was a changing mix of capitalist, socialist, and traditional features with strong financial and technological links to the United States, the leading capitalist nation. [ ]

#### **The Balance of Classes Under the Shah**

The Shah's economic programs helped his own associates, the Western-trained technocrats, new industrial capitalists, skilled urban workers, and foreign suppliers and experts. They hurt the clergy, rural landowners, old-style merchants, and landless agricultural workers. The programs secularized, monetized, and internationalized the economy. They provided major improvements in material well-being for many people while worsening the distribution of income in both rural and urban areas and greatly raising expectations on all sides. [ ]

#### **The Fall of the Shah**

At the beginning of 1978, only 13 months before the fall of the Shah, learned observers wrote of his apparently solid political, economic, and military position. In retrospect, we know that beneath the show

of rising income and consumption, strong anti-Shah currents were at work:

- Resentment by the Islamic clergy over the secularization of educational, political, and economic affairs and the consequent loss of clerical influence.
- Uprooting of millions of lower-class workers as the result of rapid changes in agriculture and industry, and an increase in their receptivity to anti-Shah movements.
- Disgruntlement of local merchants and capitalists who had been hurt by the new competitive forces and their own loss of status.
- Disaffection of nationalists, who felt especially bitter over the legal and economic privileges of Americans in Iran.
- Alienation of intellectuals who saw Iran being turned into an unproductive consumption economy, "one huge assembly of flea markets hawking European manufactured goods."
- Indiscipline of the military rank and file because many soldiers had come from disadvantaged classes and often had been drafted against their will. [ ]

25X1

25X1

These forces, however, would not have proved an explosive mixture if the Shah had not vacillated in dealing with his enemies or if the exiled Ayatollah Khomeini had not provided such shrewd leadership. One observer sums up the final scene: "In February 1979, the 50-year-old Pahlavi monarchy collapsed in a brief two-day popular uprising. The uprising delivered the coup de grace to a regime that had already been battered and broken by a year of street clashes, strikes, and demonstrations." [ ]

25X1

25X1

#### **Missed Opportunity**

The Shah, whose arrogance grew with his power and wealth, badly mishandled the task of modernization in Iran. Although some highly useful industrial and agricultural projects were completed and hundreds of thousands of technical people were trained, the Shah tried to modernize at a pace far beyond the absorptive capacity of the country's political and social systems. He wasted tens of billions of oil dollars, which could have been the means of fashioning an independent, progressive nation, able to fend for itself when the oil ran out. [ ]

25X1

25X1

**Confidential**

**Confidential**